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BANK DIRECTORS' DUTIES UNDER THE
COMMON LAW OF ARKANSAS

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I. INTRODUCTION

Concern over the health of depository institutions¹ has mounted over the past decade. Savings and loan institutions and their problems have received the most attention, perhaps justifiably: estimates of the cost to resolve the problems at the approximately 340 insolvent savings and loans operating at the end of 1988² range from \$85 billion³ to \$100 billion.⁴ While not as well publicized, banks are also experiencing capitalization problems: there were 221 bank fail-

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1. This generic term applies to a class of institutions such as commercial banks, savings and loans, savings banks, and credit unions. For further explanation of the term, and a discussion of the elements of the class it represents, see 1 M. MALLOY, *THE CORPORATE LAW OF BANKS*, §§ 1.1-1.2 (1988).

2. U.S. GEN'L ACCT. OFFICE, *RESOLVING THE SAVINGS & LOAN CRISIS* 2 (Jan. 26, 1989) (document GAO/T-GGD-89-3) (statement of Charles A. Bowsher, Comptroller General of the United States, before the Committee on the Budget of the United States House of Representatives) [hereinafter Bowsher].

3. *Id.*

4. Moore, *The Bust of '89*, U.S. NEWS & WORLD REPORT, Jan. 23, 1989, at 36.

ures in 1988, a post-Depression record.⁵

Many of the savings and loan failures are now being linked to fraud and other mismanagement on the part of owners, directors, and officers.⁶ Whatever the cause, regulatory actions brought by federal regulators against directors and officers of banks and savings and loans are on the rise.⁷

With this increased attention to the duties of directors in mind, this article examines the common law duties owed by directors of banks⁸ in Arkansas. While this article focuses on Arkansas common law, one should keep in mind that federal statutes⁹ and federal common law¹⁰ circumscribe the duties of bank directors to a very large degree. State statutes also impose duties on directors of state banks.¹¹ Where these sources of law do not supply needed rules, though, courts utilize state common law to ascertain directors' duties.¹² By reviewing the cases, this article will set forth some of the common law

5. Arkansas Gazette, March 15, 1989, at C3; see also Bowsher, *supra* note 2, at 7 (noting a recent growth in the number of inadequately capitalized banking institutions).

6. Moore, *supra* note 4, at 37 *passim*; Arkansas Gazette, January 28, 1989, at C2.

7. Vartanian & Schley, *Bank Officer and Director Liability—Regulatory Actions*, 39 BUS. LAW. 1021 (1984).

8. The reported decisions found by this author, concerning directors' duties in the context of depository institutions in Arkansas, all involve banks. Therefore, this article will refer to bank directors. The point has been made that savings and loans are also "depository institutions." See *supra* note 1. Thus, these duties should also apply to directors of savings and loans in Arkansas. See 1 M. MALLOY, *supra* note 1, § 3.2.6 (discussing the duties of directors of depository institutions without distinguishing between banks and savings and loans).

9. *E.g.*, First National Bank v. Rushton, 251 Ark. 74, 77, 472 S.W.2d 945, 946 (1971); see also 1 M. MALLOY, *supra* note 1, §§ 3.1, 3.2.6, at 234 (noting some statutes); Vartanian & Schley, *supra* note 7, at 1021 *passim* (discussing federal regulatory options and the underlying statutes).

10. Some courts have held that the directors of federally chartered depository institutions are subject to federal, not state, common law. *E.g.*, Eureka Fed. Sav. & Loan Ass'n v. Kidwell, 672 F. Supp. 436 (N.D. Cal. 1987); see also 1 M. MALLOY, *supra* note 1, § 3.1 (1988 & 2d Cum. Supp. 1988). Other courts have mixed federal statutory law and state common law in discussing directors' duties. *E.g.*, Lane v. Chowning, 610 F.2d 1385 (8th Cir. 1979) (applying Arkansas' common law); see also 1 M. MALLOY, *supra* note 1, § 3.1.

The former line of authorities calls into question the relevance of state common law. Even if federal common law is found to control, a federal court may adopt state common law and apply it as federal law. C. WRIGHT, THE LAW OF FEDERAL COURTS § 60 (4th ed. 1983). It is not clear whether the *Lane* court was incorporating Arkansas law as federal common law or simply judging the actions of directors of a federally-chartered bank based on state common law duties. In either instance, it appears that Arkansas common law is relevant in the Eighth Circuit, regardless of whether the Arkansas depository institution has a federal charter.

11. *E.g.*, ARK. CODE ANN. § 23-32-907 (1987) (directors' liability for violation of loan limitations).

12. *E.g.*, Lane, 610 F.2d 1385; Bank of Commerce v. Goolsby, 129 Ark. 416, 435, 196 S.W. 803, 809 (1917); see 1 M. MALLOY, *supra* note 1, § 3.1. See also First National Bank v. Rushton, 251 Ark. 74, 85, 472 S.W.2d 945, 951-52 (1971) (Fogleman, J., dissenting).

duties imposed in Arkansas. More importantly, this article aspires to place those duties into a meaningful context. By reviewing the factual situations in which the courts have applied common law duties, this article will illustrate the behavior necessary for a director to fulfill his obligations, thereby avoiding liability under the common law.

II. WHO IS A DIRECTOR?

All banks, whether federally or state chartered, are managed and controlled by a board of directors.¹³ For the time that they serve, directors are subject to the common law duties discussed below.¹⁴ An initial consideration involves determining the steps necessary to assume the position of director and the steps necessary to terminate it.

A. Election and Acceptance

Directors are generally elected by the bank's shareholders.¹⁵ However, an individual is not automatically subjected to a director's duties simply because he was elected to that position. Only after accepting a position does a director become subject to liability for breach of his duties.¹⁶

In *Bank of Des Arc v. Moody*,¹⁷ the Arkansas Supreme Court determined that certain directors were liable for breach of their common law duties. One alleged director, Vaughan, argued that he never accepted a directorship, so he should not be held liable for the plaintiffs' damages.¹⁸ While there was proof that the bank's shareholders had elected Vaughan as director, Vaughan testified to the contrary.

[H]e testified that he was not present at the meeting [at which he was elected], and never received any notice or information that he was elected a director, and never acted as such and had nothing to do with the management of the bank until he was called in to assist the cashier after the [bad] loans were made.¹⁹

There was no contrary testimony on these points, so the supreme court reversed the trial court's decree against Vaughan on the basis of

13. 12 U.S.C. § 71 (1982); ARK. CODE ANN. § 23-32-224 (Supp. 1987); 10 AM. JUR. 2D *Banks* § 178 (1963).

14. 10 AM. JUR. 2D *Banks* § 195 (1963).

15. 12 U.S.C. § 71 (1982); ARK. CODE ANN. § 23-32-224 (Supp. 1987).

16. *Zimmerman v. Western & Southern Fire Ins. Co.*, 121 Ark. 408, 412, 181 S.W. 283, 285 (1915); *Bank of Des Arc v. Moody*, 110 Ark. 39, 42, 161 S.W. 134, 135 (1913).

17. 110 Ark. 39, 161 S.W. 134 (1913).

18. *Id.* at 42, 161 S.W. at 135.

19. *Id.*

his liability as a director.²⁰

This issue arose again in *Zimmerman v. Western & Southern Fire Insurance Co.*²¹ Evidence supported the trial court's finding that a bank's directors were liable for "gross mismanagement of the affairs and business of the bank, causing considerable loss to the depositors and stockholders."²² In challenging the judgment, Zimmerman claimed the protection of the statute of limitations; he argued that he ceased to be a director at a point outside the statute. The Arkansas Supreme Court agreed.²³ The minutes of the shareholders' meetings demonstrated that Zimmerman was elected director through the year 1909. However, testimony demonstrated that Zimmerman offered to resign in March of 1906. The bank's president persuaded Zimmerman not to resign, on the promise that he would not be reelected director at the April 1906 meeting. Apparently, Zimmerman did not attend the April meeting, and never knew of his subsequent reelection until after the bank had been placed into receivership.²⁴ The court stated the applicable rule as follows:

The minutes of the corporation were very loosely kept and were unsigned, but, conceding that they were competent evidence tending to show the election of Zimmerman as a director, that testimony is subject to be rebutted; and, in addition to that, in order to hold Zimmerman liable, it is essential that he should have accepted the appointment There must be an acceptance of the office of director before any liability can flow from the failure to discharge the duties of the office.²⁵

The court held that the evidence was in Zimmerman's favor; determinative factors included Zimmerman's proposed resignation and his prior refusal to serve after the April 1906 meeting.²⁶

A director's duties therefore arise only after an individual has been elected director and has accepted that position. Election alone is clearly not sufficient grounds to impose a director's duties on an individual.²⁷ Factors indicating acceptance include knowledge of the election, either through attending the shareholders' meeting or otherwise, exercising the duties of a director, and assistance in the manage-

20. *Id.* at 42-43, 161 S.W. at 136.

21. 121 Ark. 408, 181 S.W. 283 (1915).

22. *Id.* at 410, 181 S.W. at 284.

23. *Id.* at 410-11, 181 S.W. at 284-85.

24. *Id.* at 411-12, 181 S.W. at 284-85.

25. *Id.* at 412, 181 S.W. at 285.

26. *Id.* at 412-13, 181 S.W. at 285.

27. *Id.* at 412, 181 S.W. at 285.

ment of the bank.²⁸ Even if the minutes indicate that one was elected director, they may be rebutted by demonstrating that the position was never accepted.²⁹

B. Resignation and Termination

A director's position could terminate through the natural expiration of his term, his resignation, or his removal from the position for regulatory or other reasons.³⁰ An aggrieved party must then sue the director within the applicable statute of limitations, or the statute will bar recovery.³¹ Once the director steps down from his position, he is not liable for subsequent mismanagement of the bank's affairs.³²

Bank directors generally have the right to resign at any time; no formal acceptance of their resignation is required.³³ While in some instances bank directors might avoid liability by resigning, circumstances may exist which indicate that the resignation itself is a breach of duty.³⁴ In those situations, liability may continue even though the right to resign is absolute.³⁵

III. THE DIRECTOR'S DUTIES

A. Generally

It is easy enough to state the rules. A bank's affairs, like those of other corporations,³⁶ are managed and controlled by a board of directors.³⁷ Their fiduciary duties are owed to the bank's shareholders and depositors³⁸ and are analogous to those duties owed by a trustee under an implied trust.³⁹ In exercising their duties, directors are held to a standard of care which requires a constant exercise of good faith

28. *Id.* at 411-13, 181 S.W. at 284-85; *Bank of Des Arc v. Moody*, 110 Ark. 39, 42, 161 S.W. 134, 135 (1913).

29. *Zimmerman*, 121 Ark. at 412, 181 S.W. at 284-85.

30. 1 M. MALLOY, *supra* note 1, § 3.2.2.

31. *Magale v. Fomby*, 132 Ark. 289, 201 S.W. 278 (1918); 10 AM. JUR. 2D *Banks* § 219 (1963).

32. 10 AM. JUR. 2D *Banks* § 195 (1963).

33. *Zimmerman*, 121 Ark. at 412, 181 S.W. at 285; see generally Tuohey, *Corporate Director Resignation*, 33 ARK. L. REV. 106, 117-20 (1979) (general discussion of this rule).

34. See Deal, *Liability of Bank Directors*, 39 BUS. LAW. 1033, 1034 (1984).

35. *Id.*; Tuohey, *supra* note 33, at 108-12.

36. ARK. CODE ANN. § 4-27-801 (Supp. 1987).

37. 12 U.S.C. § 71 (1982); ARK. CODE ANN. § 23-32-224 (Supp. 1987); 1 M. MALLOY, *supra* note 1, § 3.2.3.

38. *Lane v. Chowning*, 610 F.2d 1385, 1388-89 (8th Cir. 1979).

39. *Magale v. Fomby*, 132 Ark. 289, 296-97, 201 S.W. 278, 280 (1918); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 435-36, 196 S.W. 803, 809 (1917).

and diligence.⁴⁰ This is not to say that directors are insurers of the bank's officers' actions,⁴¹ or that directors are liable for the mere exercise of poor judgment.⁴² But directors must exercise constant diligence and good faith,⁴³ and when they fail to do so through negligent attention to their duties, directors will be liable to shareholders and depositors for losses resulting from that negligence.⁴⁴

A review of the cases is more instructive than a restatement of the rules. How are these rules applied in practice? Given that there are various aspects of bank management requiring a director's attention, how do these rules apply to those various matters?

B. The Duty to Give Attention to and Control the Bank's Affairs

1. Generally

Bank directors have a duty to exercise reasonable attention to and control over their bank's affairs.⁴⁵ A model of the degree of attention and control required, characterized by the Arkansas Supreme Court as "the greatest diligence,"⁴⁶ is as follows:

The board of directors met regularly, not less than once each month, and frequently oftener, at which time a typewritten copy of a statement was given to each director showing all transactions since the last meeting, including the paper still on hand and also that acquired since the last previous meeting. The board had an auditing committee which functioned regularly. The managing officers were shown to have acted pursuant to and in accordance with resolutions duly passed by the board of directors, no loan was made until it had been duly examined and approved by the officers having that authority.⁴⁷

Of course, the degree of attention and control may vary from instance to instance, depending upon "the peculiar facts and circumstances of each particular case."⁴⁸

One case depicting directors at their best and worst is *Ford v.*

40. *Sternberg v. Blaine*, 179 Ark. 448, 452-53, 17 S.W.2d 286, 288 (1929); *Goolsby*, 129 Ark. at 435-39, 196 S.W. at 809-10; 1 M. MALLOY, *supra* note 1, § 3.2.6; 10 AM. JUR. 2D *Banks* §§ 181-82 (1963).

41. *Goolsby*, 129 Ark. at 439, 196 S.W. at 810; 10 AM. JUR. 2D *Banks* § 190 (1963).

42. *Muller v. Planters' Bank & Trust Co.*, 169 Ark. 480, 486-87, 275 S.W. 750, 752 (1925); 10 AM. JUR. 2D *Banks* § 183 (1963).

43. *Sternberg*, 179 Ark. at 452-53, 17 S.W.2d at 288.

44. *Id.*; 1 M. MALLOY, *supra* note 1, § 3.2.6; 10 AM. JUR. 2D *Banks* § 181 (1963).

45. *Goolsby*, 129 Ark. at 437-38, 196 S.W. at 809-10.

46. *Milburn v. Martin*, 190 Ark. 16, 19-20, 76 S.W.2d 952, 954 (1934).

47. *Id.* at 20, 76 S.W.2d at 954.

48. *Goolsby*, 129 Ark. at 439, 196 S.W. at 810.

Taylor.⁴⁹ Prior to January of 1925, the directors of the Peoples' Bank of Ozark had exhibited adequate attention to and control over the bank's affairs. For instance, "they had met regularly, and had kept their records properly, and had a discount committee which had functioned, and the directors had made an audit of the bank's affairs in the year 1924."⁵⁰ While the directors may have demonstrated poor judgment, that was not sufficient grounds for liability. The court reasoned that shareholders assumed the risk of losses from "mere defects in judgment" when they selected directors; the directors "merely assum[ed] the obligation to manage the affairs of the institution with diligence and good faith."⁵¹

However, the Peoples' Bank of Ozark underwent an examination by the state regulatory authorities in January of 1925. In the studied words of the Arkansas Supreme Court, "it was a mere matter of indulgence on the part of the examiner that the bank was permitted to continue in business."⁵² The directors received a copy of the examiner's report, which highlighted a variety of problems: the bank's president had executed two notes to it and had indorsed one on his brother's behalf; other officers and employees of the bank had taken loans from it; there was a deficit in the bank's reserve; and "the practice of permitting overdrafts appeared to be habitual . . ."⁵³

Once the examination report placed the directors on notice of the bank's problems, their duty of diligence and good faith in attending to and controlling the bank's affairs "required them to give closer attention to the bank's affairs than they had previously done."⁵⁴ The directors breached this duty. There was no audit of the bank's books made during 1925; there was no effective loan review committee; directors never examined the notes held by the bank; the directors skipped one monthly meeting; "and no minutes of any meeting after September [1925] were ever written up, or approved or signed by the board or its officers."⁵⁵

The directors' negligence was particularly evident in their attention to the activities of the bank's cashier. Beginning in 1925, the cashier did his best to contribute to the local economy. He purchased 80 acres within the city limits, built himself an expensive house, and

49. *Ford v. Taylor*, 176 Ark. 843, 4 S.W.2d 938 (1928).

50. *Id.* at 849, 4 S.W.2d at 940.

51. *Id.*

52. *Id.* at 848, 4 S.W.2d at 940.

53. *Id.* at 848-49, 4 S.W.2d at 940.

54. *Id.* at 849, 4 S.W.2d at 940.

55. *Id.* at 850-51, 4 S.W.2d at 941.

built a "business house on one of the principal streets."⁵⁶ The cashier speculated "in oil ventures; he operated a coal mine; he invested in a diamond cave, and assisted in promoting a vineyard company and a life insurance company. . . ."⁵⁷ The cashier financed these speculations with loans from the bank, otherwise unauthorized.⁵⁸

The cashier's systematic course of conduct was so obvious to the supreme court that "detection must have resulted from any reasonable attempt at supervision."⁵⁹ A mere exercise of their duty to act in good faith and with reasonable diligence would have enabled the directors to detect the cashier's activities.⁶⁰

We do not hold that the directors were insurers of the honesty or good faith of the cashier, or that they became liable for his fraudulent conduct simply because they were directors, for such is not the law as announced in the prior decisions of this court. But we do hold them liable for their lack of diligence and good faith in supervising the affairs of the bank. Their inattention to the bank's affairs furnished the cashier assurance that the boldest and most flagrant conduct on his part would escape their detection and give the cashier an opportunity to loot the bank systematically.⁶¹

Based on the testimony, the Arkansas Supreme Court held the directors liable for losses incurred by the bank subsequent to January of 1925.⁶²

Ford is a good illustration of the conduct required of bank directors. They must exercise good faith and diligence at all times.⁶³ Factors indicating such attention and control include regular audits,⁶⁴ regular meetings as recorded by properly kept minutes,⁶⁵ attention to the bank's officers' activities,⁶⁶ and some degree of attention to the lending and other operations of the bank.⁶⁷ When directors are placed on notice of potential problems, by examination reports or otherwise, then their duty of good faith and diligence requires height-

56. *Id.* at 850, 4 S.W.2d at 940-41.

57. *Id.*

58. *Id.*

59. *Id.* at 852, 4 S.W.2d at 941.

60. *Id.*

61. *Id.*

62. *Id.* at 853, 4 S.W.2d at 942.

63. *Id.* at 847-48, 4 S.W.2d at 939-40; 10 AM. JUR. 2D *Banks* §§ 181-82 (1963).

64. *Ford*, 176 Ark. at 849, 4 S.W.2d at 940-41.

65. *Id.*

66. *Id.* at 851-52, 4 S.W.2d at 941 (failure to monitor cashier one factor in sustaining directors' liability).

67. *Id.* at 850-52, 4 S.W.2d at 940-41 (failure to review loans adequately and to review notes).

ened attention to the bank's affairs.⁶⁸

This latter point is illustrated by *Sternberg v. Blaine*.⁶⁹ The Bank of Blytheville's cashier and his assistant had, over a three year period, stolen approximately \$800,000 from the bank. Their activities remained undiscovered by the bank's other officers and the bank examiners over this period due to the extreme care with which they doctored the bank's books.⁷⁰ Other than this situation, no evidence of the directors' negligence or mismanagement existed.⁷¹ A majority of the Arkansas Supreme Court held that the bank's directors were not liable for the losses.⁷²

In the absence of any reason to suspect the honesty of the cashier, there is no duty upon the directors to do more than is ordinarily done by directors of a bank of this kind. A bank director is not required to be an expert nor a competent bookkeeper, nor to do more in the general management of the bank, with reference to its cashier and bookkeeper, than to see that the statements made to the board correspond to the books, unless there is some reason for doubting the fidelity of the trust confided to the cashier or bookkeeper. Knowledge of all of the affairs of the bank cannot be imputed to a director for the purpose of charging him with liability, unless there is something about the conduct of the cashier or bookkeeper or about the affairs of the bank that would arouse the suspicion of a man of ordinary prudence.⁷³

2. *Factors Negating Liability: Poor Judgment and Hard Times*

Generally, courts will not hold bank directors liable for the exercise of poor judgment.⁷⁴ Such "poor judgment" is often found in the context of an economic downturn, which renders the bank's assets somewhat devalued.

In *Muller v. Planters' Bank and Trust Co.*,⁷⁵ shareholders of a defunct bank sued its ex-directors for alleged negligent operation of

68. *Id.* at 849, 4 S.W.2d at 940.

69. *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929).

70. *Id.* at 450-51, 454-55, 457; 17 S.W.2d at 288-90.

71. *Id.* at 451, 17 S.W.2d at 288-89 (indicating regular meetings, review of notes, and examinations by directors).

72. *Id.* at 458, 17 S.W.2d at 290.

73. *Id.* at 456-57, 17 S.W.2d at 290; see 10 AM. JUR. 2D *Banks* §§ 190, 192 (1963).

74. *Ford v. Taylor*, 176 Ark. 843, 849, 4 S.W.2d 938, 940 (1928); *Muller v. Planters' Bank & Trust Co.*, 169 Ark. 480, 486-87, 275 S.W. 750, 752 (1925); 10 AM. JUR. 2D *Banks* § 183 (1963).

75. 169 Ark. 480, 275 S.W. 750 (1925).

the bank. The trial court found that the bank was prospering until the summer of 1920. The economy then underwent a "depreciation in values" which "progressed so rapidly that by the autumn of that year there was a slump in values that caused heavy losses to all business enterprises, especially to banking institutions which held collateral from farmers and merchants."⁷⁶

The court found that the bank's losses resulted in part from poor judgment in making loans, and in greater part from an economic downturn, "for which no one connected with the institution was responsible."⁷⁷ The court then enunciated the applicable rule:

The substance, therefore, of the test laid down . . . of the responsibility of directors to stockholders as well as to creditors is good faith and diligence. The mere exercise of poor judgment is not sufficient to form a basis of liability, for when directors are selected by the stockholders the latter assume the risk of losses occurring on account of mere defects in judgment, and in acceptance of the office by the director he merely assumes the obligation to manage the affairs of the institution with diligence and good faith.⁷⁸

Here, the directors exercised such diligence and good faith, and the court refused to hold them liable for poor economic conditions.⁷⁹

A similar situation occurred in *Ford v. Taylor*.⁸⁰ The Peoples' Bank of Ozark had suffered losses prior to January of 1925 due to bad loans. However, "[m]ost of the loans then existing were renewals of old loans made in more prosperous times and to persons who were regarded as good when these loans were made."⁸¹ After an economic slump, customers previously regarded as good credit risks were unable to meet their commitments. While the directors exercised poor judgment in approving a number of these loans, the Arkansas Supreme Court cited *Muller* in relieving the directors of liability for these loans.⁸²

It is important to note that the directors in *Ford* and *Muller* did no more than exercise poor judgment. Had there been inattention on their part, or some other breach of duty, the results may have been different. But, poor judgment standing alone was not indicative of negligence.

76. *Id.* at 481, 484, 275 S.W. at 751.

77. *Id.* at 485, 275 S.W. at 751.

78. *Id.* at 486-87, 275 S.W. at 752.

79. *Id.* at 487, 275 S.W. at 752.

80. *Ford v. Taylor*, 176 Ark. 843, 4 S.W.2d 938 (1928).

81. *Id.* at 849, 4 S.W.2d at 940.

82. *Id.* (citing *Muller*, 169 Ark. at 486-87, 275 S.W. at 752).

3. *Directors' Audits*

One factor indicative of the directors' attention and control is the practice of independently auditing the bank's books.⁸³ A directors' audit tends to support a finding of good faith and diligence;⁸⁴ the absence of independent audits can be some evidence of negligence.⁸⁵ The entire board need not conduct the audit. The bank's board of directors could create an audit committee and appoint a subset of its members to conduct an audit.⁸⁶ The remaining directors may then rely on the audit committee's findings, if they reasonably believe the audit committee merits their confidence.⁸⁷

4. *Examiners' Reports*

Bank regulators generally are required by law to examine a bank's affairs on a regular basis and to report on their findings.⁸⁸ When the examination reports bring problems to the attention of directors, they are required to give those problems closer attention.⁸⁹

The failure of bank examiners to detect a problem might work in the directors' favor in an unintended manner. In *Sternberg v. Blaine*,⁹⁰ the Arkansas Supreme Court noted that bank examiners failed to discover a bank's losses over the course of a three-year period. There was no evidence that the bank examiners were negligent in the performance of their duties.⁹¹ Even if there had been such evidence, "while a failure of the bank examiner to perform his duty did not excuse the directors from the performance of their duties, . . . the fact that [the bank] was examined regularly by the bank examiners is a circumstance tending to show that the directors were not negligent in the performance of their duties."⁹² Thus, a bank examiner's failure to discover wrongdoing may be some evidence of the absence of negligence on the part of the bank's directors.

83. See Deal, *supra* note 34, at 1035 (noting the importance of an audit committee).

84. Ford, 176 Ark. at 849, 4 S.W.2d at 940.

85. *Id.* at 850, 851, 4 S.W.2d at 941.

86. ARK. CODE ANN. § 4-27-825 (Supp. 1987); Deal, *supra* note 34, at 1035.

87. ARK. CODE ANN. § 4-27-830.B.3 (Supp. 1987); Deal, *supra* note 34, at 1035-36.

88. 12 U.S.C. § 1820(b) (1982); ARK. CODE ANN. § 23-32-1103 (Supp. 1987); 10 AM. JUR. 2D Banks § 18 (1963).

89. Ford, 176 Ark. at 849, 4 S.W.2d at 940; see Deal, *supra* note 34, at 1036.

90. 179 Ark. 448, 17 S.W.2d 286 (1929).

91. *Id.* at 456, 17 S.W.2d at 289.

92. *Id.*

C. Duty to Select, Oversee, and Retain Competent Management

Typically, a board of directors will delegate some responsibility for the day-to-day management of the bank to their executive officers.⁹³ This delegation imposes additional duties on the directors. A bank's directors must exercise due care in the selection, oversight, and retention of the bank's executive officers.⁹⁴

A leading Arkansas case on this point, and on directors' duties in general, is *Bank of Commerce v. Goolsby*.⁹⁵ Apparently, the directors of the Bank of Commerce allowed their officers to run amuck. The president and cashier of the bank issued a series of misleading financial statements depicting a healthier condition at the bank than actually existed; the directors were well aware of this practice.⁹⁶ The cashier of the bank engaged in a financial arrangement with a pawnbroker which "virtually put the bank in partnership with [the pawnbroker] in the pawnbrokerage business."⁹⁷ As collateral for his loans, the pawnbroker provided the cashier with notes which were usurious on their face, and therefore void.⁹⁸ Although the cashier had his own financial problems, the directors permitted him to borrow \$2,800 of the bank's money "without questions and without security."⁹⁹

The Arkansas Supreme Court held that the directors were liable for the losses caused by the officers' conduct.¹⁰⁰ The court noted that the relationship between bank directors and bank shareholders is more analogous to the relationship between a trustee and his trust beneficiary, as opposed to the relationship between an agent and his principal.¹⁰¹ Bank directors must exercise ordinary care and diligence in the performance of their duties.¹⁰² The Arkansas Supreme Court related this general standard of care to the directors' supervision of their officers as follows:

93. 1 M. MALLOY, *supra* note 1, § 3.2.4; 10 AM. JUR. 2D *Banks* § 190 (1963).

94. *Lane v. Chowning*, 610 F.2d 1385, 1388 (8th Cir. 1979) (directors had a duty to investigate and remove misbehaving officers); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 437, 196 S.W. 803, 809 (1917) (directors must exercise reasonable control and supervision over banks' officers); *Fletcher v. Eagle*, 74 Ark. 585, 588, 86 S.W. 810, 811 (1905) (directors can't abdicate their management duties to officers). See Annotation, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3D 941 (1969).

95. 129 Ark. 416, 196 S.W. 803 (1917).

96. *Id.* at 426-27, 196 S.W. at 806.

97. *Id.* at 441, 196 S.W. at 811.

98. *Id.*

99. *Id.* at 442, 196 S.W. at 811.

100. *Id.* at 442-43, 196 S.W. at 811.

101. *Id.* at 435-36, 196 S.W. at 809.

102. *Id.* at 439, 196 S.W. at 810.

It is their duty to use ordinary diligence in ascertaining the condition of [the bank's] business, and to exercise reasonable control and supervision over its officers. . . . That which [the directors] ought, by proper diligence, to have known as to the general course of business in the bank, they may be presumed to have known, in any contest between the corporation and those who are justified by the circumstances in dealing with its officers upon the basis of that course of business.¹⁰³

The court did not hold that the directors were "insurers of the fidelity or capacity of the cashier or other agents to whom the business and assets of the bank may be entrusted. . . ." ¹⁰⁴ The directors were merely "required to exercise due care in [the officers'] selection and proper supervision over their action."¹⁰⁵

In this instance, the directors were clearly liable for the actions of the officers. The directors knew, or could have known, of the false financial statements, the bad loans to the pawnbroker, and the cashier's other misdealings.¹⁰⁶ Indeed, the cashier "was encouraged in his reckless handling of the bank's funds . . . by knowledge of the fact that the directors were giving practically no attention to the matter of loans. . . ." ¹⁰⁷ The directors knew or could have known of the officers' gross negligence had they exercised ordinary care in the management of the bank's affairs and business.¹⁰⁸ Since they did not, the directors were held jointly and severally liable for the losses suffered by the bank.¹⁰⁹

In contrast, the directors at the Planters' Bank knew how to properly oversee the actions of the bank's cashier.¹¹⁰ The directors personally attended to the affairs of the bank and supervised the cashier's work to some extent. When they learned of problems relating to the cashier's actions, they immediately placed restrictions upon him. They also promptly acted to recover upon the cashier's surety bond.¹¹¹ These facts, and others, led the Arkansas Supreme Court to absolve the directors of liability for the bank's subsequent losses.¹¹²

103. *Id.* at 437-38, 196 S.W. at 810 (quoting *Martin v. Webb*, 110 U.S. 7, 15 (1884)).

104. *Id.* at 439, 196 S.W. at 810.

105. *Id.*

106. *Id.* at 439-43, 196 S.W. at 810-11.

107. *Id.* at 442, 196 S.W. at 811.

108. *Id.* at 442-43, 196 S.W. at 811.

109. *Id.*

110. *Muller v. Planters' Bank & Trust Co.*, 169 Ark. 480, 484-85, 275 S.W. 750, 751-52 (1925).

111. *Id.*

112. *Id.* at 484-87, 275 S.W. at 752.

The degree of supervision that directors should exercise over bank officers depends upon the bank's particular circumstances. If the directors have no notice of an officer's dereliction of duty, the directors are not expected to take extraordinary precautions to guard against the officer's misconduct.¹¹³ Once they have notice of such dereliction, however, directors must give heightened attention to the matter and act promptly to resolve it.¹¹⁴

These rules are illustrated by *Lane v. Chowning*,¹¹⁵ an Eighth Circuit opinion. When the directors of Union National Bank became suspicious of the activities of two of its officers, they voted to remove them from their positions. Subsequently, one of the officers was convicted for criminal activities in which he had engaged while managing the bank.¹¹⁶ This ex-officer then sued the board of directors, claiming they induced him to enter into the criminal activity. The Eighth Circuit first noted that bank directors owe their duties to the bank's depositors and shareholders, and not to the bank's officers.¹¹⁷ Thus,

[t]he duty of the directors in this proceeding clearly was to remove [the officers] from power. In fact, the failure to investigate and remove these men could have resulted in personal liability for the directors and officers.¹¹⁸

Nor did the directors act out of questionable motives; "under the law of Arkansas, the directors had an obligation to exercise reasonable control over the affairs of the bank."¹¹⁹

In some instances, directors may not be liable for losses caused by officers. Where directors could not reasonably be expected to discover an officer's concealed transactions, the directors are not liable for subsequent losses.¹²⁰ On the other hand, where the officer's conduct is so systematic that it would be observed through the exercise of due diligence, concealment is no defense to a director's liability.¹²¹

D. Duty to Ensure Proper Lending Practices

Bank directors must devote some attention to their bank's lend-

113. *Sternberg v. Blaine*, 179 Ark. 448, 456-57, 17 S.W.2d 286, 290 (1929).

114. *Ford v. Taylor*, 176 Ark. 843, 4 S.W.2d 938 (1928).

115. 610 F.2d 1385 (8th Cir. 1979).

116. *Id.* at 1387.

117. *Id.* at 1388-89.

118. *Id.* at 1389.

119. *Id.* at 1390.

120. *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929).

121. *Ford v. Taylor*, 176 Ark. 843, 851-52, 4 S.W.2d 938, 941 (1928).

ing practices and policies.¹²² When directors do not adequately manage the lending practices of the bank's officers, they may be held liable for failure to control those practices.¹²³ On the other hand, if loan losses result from poor judgment or an economic down turn, courts will generally not hold directors liable.¹²⁴

*Magale v. Fomby*¹²⁵ presents an example of how not to conduct commercial lending. Several directors and officers of the Columbia County Bank organized a canning factory, which subsequently did business with the bank. The canning company was never very successful. From the time of its inception in early 1909 until December 15, 1911, the canning company borrowed \$29,421.04 from the bank.¹²⁶ Until late in 1911, all the bank had to show for its loans was "notes . . . , overdrafts and accounts;" at that time, the bank took a mortgage for the entire amount of the debt.¹²⁷ The bank later charged off \$16,000 worth of the debt, and the stockholders of the bank eventually made up the balance.¹²⁸

The Arkansas Supreme Court found that the bank's directors "were guilty of such reckless conduct in the management of the affairs of the bank as to constitute negligence" ¹²⁹ This finding was based upon the bank's relationship with the canning company. The bank's directors were not guilty of fraud in making the loans to the canning factory, but other factors of the transaction seemed to trouble the court: the bank took no security for its loans until after it ceased to make them to the canning company; the bank allowed the canning company to become indebted to the bank in an amount approximating three-fifths of the bank's capital stock; and the directors did not adequately assess the canning company's chance of success.¹³⁰

[T]hey believed the business would be successful. It is not shown, however, that any of them had any experience in operating a canning factory. It turned out to be a hazardous business and one that required skill and experience on the part of those managing it in order to make it a success.¹³¹

The directors were not held liable for the bank's losses, however, since

122. 1 M. MALLOY, *supra* note 1, § 3.2.6; 10 AM. JUR. 2D *Banks* § 193 (1963).

123. *E.g.*, *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917).

124. *E.g.*, *Muller v. Planters' Bank & Trust Co.*, 169 Ark. 480, 275 S.W. 750 (1925).

125. 132 Ark. 289, 201 S.W. 278 (1918).

126. *Id.* at 291-92, 201 S.W. at 278.

127. *Id.* at 292, 201 S.W. at 278-79.

128. *Id.*

129. *Id.* at 296, 201 S.W. at 280.

130. *Id.* at 295-96, 201 S.W. at 280.

131. *Id.* at 295, 201 S.W. at 280.

the applicable statute of limitations had run.¹³²

Magale and *Goolsby* support the proposition that directors should apprise themselves of the nature and condition of the bank's larger commercial borrowers.¹³³ Other aspects of the bank's lending policy may also demand the directors' attention. These include whether security should be taken for loans,¹³⁴ and the amount which any one particular borrower will be permitted to draw.¹³⁵ Further, directors should make some provision for reviewing their institution's loans.¹³⁶

IV. LIMITATION OF LIABILITY UNDER THE NEW BUSINESS CORPORATION ACT

Directors of banks governed by the Business Corporation Act of 1987¹³⁷ may have their common law liability limited. Under the Act, a corporation may include a provision in its Articles of Incorporation limiting the personal liability of its directors to the corporation or its stockholders for any breach of their fiduciary duty.¹³⁸ However, directors are still liable for a breach of their duty of loyalty, acts not taken in good faith, intentional misconduct, knowing violations of the law, unlawful distributions, improper personal benefit, and any breach creating liability to a third party.¹³⁹

How would the adoption of such a provision affect a banking corporation's directors? The common law duties discussed above generally result in liability for directors if there is a finding of negligent conduct.¹⁴⁰ However, one part of the new Act requires more culpable conduct; directors are liable only "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. . . ."¹⁴¹ Does this make it more difficult to establish a

132. *Id.* at 298, 201 S.W. at 280-81.

133. *See Magale v. Fomby*, 132 Ark. 289, 295-96, 201 S.W. 278, 279-80 (1918); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 441-42, 196 S.W. 803, 810-11 (1917).

134. *See Magale*, 132 Ark. at 295, 201 S.W. at 279-80 (noting a failure to secure loans).

135. *See id.* (noting significance of one borrower's debt).

136. *See Goolsby*, 129 Ark. at 430, 196 S.W. at 807 ("Generally two or three members of the board of directors ought to be in the bank and discuss with the cashier the loans."); 10 AM. JUR. 2D *Banks* § 193 (1963).

137. Act of April 14, 1987, No. 958, 1987 Ark. Acts 3096 (Adv. Leg. Serv.) (codified at ARK. CODE ANN. §§ 4-27-101 to -1706 (Supp. 1987)). For a survey of the Act, see Brewer, *An Overview of the 1987 Arkansas Business Corporation Act*, 10 UALR L.J. 431 (1987-88).

138. ARK. CODE ANN. § 4-27-202.B.3 (Supp. 1987); Brewer, *supra* note 137, at 436.

139. *Id.*

140. *E.g.*, *Sternberg v. Blaine*, 179 Ark. 448, 453, 17 S.W.2d 286, 288 (1929); *see* 10 AM. JUR. 2D *Banks* § 181 (1963).

141. ARK. CODE ANN. § 4-27-202.B.3(ii) (Supp. 1987).

breach of the common law duties discussed above?

Perhaps not. One Arkansas case involved the liability of bank directors under an "intentional negligence" standard, which is comparable to the higher standard allowed by the new Act.¹⁴² *Bailey v. O'Neal*¹⁴³ concerned an action brought by depositors against the directors of a bank. At that time, the statutes relating to corporations in Arkansas required that the directors "intentionally neglect or refuse to comply with the provisions" of the statutes before joint and several liability would be imposed.¹⁴⁴ Thus, the bank directors were liable under the statute only if they acted intentionally. This statute is analogous to the new Act's provision limiting liability to acts "not in good faith or which involve intentional misconduct . . ."¹⁴⁵ The Arkansas Supreme Court considered the liability of the bank's directors under this statute, and did not apply the common law standard of simple negligence.¹⁴⁶

[The statutes] do not make the directors liable for a single act of negligence, however inconsequential; but they make them liable for a series of connected acts of negligence continued for such a length of time as it must be inferred that their acts of negligence were intentional.¹⁴⁷

The facts of *Bailey* were as follows. The bank was organized in 1899. Almost from the time it commenced business, its chief borrower was Kelley, or one of the corporations under his control.¹⁴⁸ By the time the bank was placed into a receivership in April of 1906, Kelley's indebtedness to the bank was so great that the Arkansas Supreme Court summarized the situation as follows: "Liabilities \$241,684.00; assets, \$324,154.44; Kelley indebtedness \$174,646.94."¹⁴⁹

The only security for Kelley's loans ever received by the bank was stock in his various corporations. Despite this lack of security, the directors continued to allow the cashier to make loans to Kelley.¹⁵⁰

Here we have the anomalous condition of directors, whose duty it

142. Compare *id.* with *Bailey v. O'Neal*, 92 Ark. 327, 329-30, 122 S.W. 503 (1909).

143. 92 Ark. 327, 122 S.W. 503 (1909).

144. *Id.* at 329-30, 122 S.W. at 504 (quoting KIRBY'S DIG. § 863 (1904)).

145. Compare *id.* with ARK. CODE ANN. § 4-27-202.B.3(ii) (Supp. 1987).

146. *Bailey*, 92 Ark. at 331, 122 S.W. at 504.

147. *Id.* at 332, 122 S.W. at 505.

148. *Id.* at 332-33, 122 S.W. at 505.

149. *Id.*

150. *Id.* at 333-34, 122 S.W. at 505.

was to manage the affairs of the bank, allowing the cashier to lend to one man in his various enterprises, without security, sums of money largely in excess of the capital stock of the bank, and to continue that course of dealing for a period of several years.

...

The inevitable result of such management of the affairs of the bank was the insolvency of the bank and of [Kelley's corporations]. Reasonable minds could come to no other conclusion, and the defendants must be presumed to have intended the natural and probable consequences of such acts of negligence on their part which continued for a period of several years, and to have assented to the negligent acts of the cashier.¹⁵¹

The directors were thus found to have acted with intentional neglect, so that they were liable under the contemporary corporation statutes.¹⁵²

Based on *Bailey*, an argument might be made that directors would be liable for extended disregard for the common law duties discussed above. If the bank directors negligently breached their duties for a sufficient period of time, a court might consider their breach intentional.¹⁵³ Thus, while the limitation of liability provision in the new Act might protect bank directors from occasional breaches,¹⁵⁴ a course of negligent conduct resulting in continued violation of the common law duties could result in personal liability to the corporation or its stockholders.¹⁵⁵

V. MISCELLANEOUS ISSUES

A. The Directors' Minutes

Minutes generally provide some evidence of the actions taken by directors at their meetings, even if the minutes are imperfectly kept.¹⁵⁶ However, the minutes are not conclusive. Directors may rebut the effect of the minutes by their own testimony.¹⁵⁷

The Arkansas Supreme Court considered the evidentiary effect of

151. *Id.* at 334, 122 S.W. at 505.

152. *Id.*

153. *Id.*

154. *Compare id.* at 332, 122 S.W. at 504-05 with ARK. CODE ANN. § 4-27-202.B.3(ii) (Supp. 1987).

155. *Compare Bailey*, 92 Ark. at 332-34, 122 S.W. at 504-05 with ARK. CODE ANN. § 4-27-202.B.3(ii) (Supp. 1987).

156. *Grand National Bank of St. Louis v. Taylor*, 176 Ark. 1, 6-7, 1 S.W.2d 818, 821 (1928).

157. *Zimmerman v. Western & Southern Fire Ins. Co.*, 121 Ark. 408, 412, 181 S.W. 283, 284-85 (1915).

minutes in *Grand National Bank of St. Louis v. Taylor*.¹⁵⁸ The Grand National Bank sued the receiver of the Peoples' Bank of Ozark, in connection with illicit transactions conducted by the latter's cashier. The cashier claimed to act under the authority of a resolution passed by the Ozark bank's directors. The resolution was found attached to a page in the board's minute book.¹⁵⁹ In finding that the resolution "was the genuine action of the board," the court stated the following rules:

The minute book of a corporation, when identified, is competent evidence as to all recitals contained therein, and, even though unsigned, the minutes may be used to prove what took place at the meeting, and that a resolution was passed thereat.¹⁶⁰

The validity of the resolution was supported by the minutes of the subsequent meeting. They showed that the minutes of the previous meeting "were read and approved," thereby supporting a finding that the board actually passed the resolution.¹⁶¹

On the other hand, a bank's minutes can be rebutted. Thus, even if the minutes indicate that an individual was elected director, their effect may be rebutted by testimony showing that the individual never accepted the position.¹⁶² And, where the minutes of the banks' board indicate that it did not meet as regularly as it perhaps should have, "[t]he minutes of the directors' meetings were not conclusive as to the extent of the attention given by the directors to the business of the institution."¹⁶³ Even though directors may subsequently have the opportunity to rebut the minutes, they should still take care to see that they are accurately kept when they are made.¹⁶⁴

B. Statute of Limitations

Section 16-56-105(3) of the Arkansas Code provides that "all actions founded on any contract or liability, expressed or implied" shall be brought within three years after the cause of action accrues.¹⁶⁵ Based on the holding of *Magale v. Fomby*, this three-year statute of limitations ought to apply to a bank director's breach of his common

158. 176 Ark. 1, 1 S.W.2d 818 (1928).

159. *Id.* at 5-6, 1 S.W.2d at 820.

160. *Id.* at 7, 1 S.W.2d at 821.

161. *Id.*

162. Zimmerman, 121 Ark. at 412, 181 S.W. at 284-85.

163. *Muller v. Planters' Bank & Trust Co.*, 169 Ark. 480, 483-84, 275 S.W. 750, 751 (1925).

164. *See Deal*, *supra* note 34, at 1037.

165. ARK. CODE ANN. § 16-56-105(3) (1987).

law duties.¹⁶⁶

In *Magale*,¹⁶⁷ a stockholder brought an action against the directors and officers of a bank. After finding that the directors and officers "were guilty of such reckless conduct in the management of the affairs of the bank as to constitute negligence,"¹⁶⁸ the Arkansas Supreme Court held that the statute of limitations barred the action.¹⁶⁹ The court noted that:

[t]he defendants rely on the statute of limitations of three years to defeat the action. Section 5064 of Kirby's Digest provides that all actions founded upon any contract or liability, expressed or implied, in writing, shall be commenced within three years after the cause of action shall accrue.¹⁷⁰

The court observed that under Arkansas law, the directors of banks "are trustees of an implied trust and are within the protection of the statute."¹⁷¹

In other words "while there is no expressed declaration of trust, [the directors'] liability in cases of this sort is implied from their official relation to the bank and there is an implied or resulting trust created by operation of law when they become directors of the bank."¹⁷² Here, the plaintiff had known of the directors' activities for over three years. There was "no fraudulent concealment of their acts by the directors that would [otherwise toll] the operation of the statute of limitations."¹⁷³ "No acts of negligence on the part of the directors occurred within three years before the bringing of the action and their liability implied from their relation to the bank is barred by the statute of limitations."¹⁷⁴

VI. CONCLUSION

This article plowed no new ground in discussing the common law duties of bank directors in Arkansas. However, given the concern over the health of depository institutions in general, and the resulting attention to directors and their duties, it is hoped that this survey will

166. Compare *id.* with *Magale v. Fomby*, 132 Ark. 289, 296-98, 201 S.W. 278, 280-81 (1918).

167. 132 Ark. 289, 201 S.W. 278 (1918).

168. *Id.* at 296, 201 S.W. at 280.

169. *Id.* at 298, 201 S.W. at 281.

170. *Id.* at 296, 201 S.W. at 280.

171. *Id.*

172. *Id.*

173. *Id.* at 297, 201 S.W. at 280.

174. *Id.* at 298, 201 S.W. at 280-81.

help bank directors avoid future losses and liability under the common law of Arkansas.

It is true that, in recent years, federal statutes and regulations have eclipsed the common law in imposing duties and liabilities upon bank directors.¹⁷⁵ However, a study of the common law would benefit more than a director's knowledge of legal history. Many of the state and federal statutory and regulatory duties are a codification or expansion of bank directors' common law duties.¹⁷⁶ To the extent that an understanding of their common law duties will help directors to understand the basis for their statutory duties, a study of the common law might assist directors in performing their duties and avoiding liability for any losses their institution might incur.

175. 1 M. MALLOY, *supra* note 1, §§ 3.1, 3.2.6.

176. See D. Melvin, *The Thirty Minute Bank Holding Company Director*, pp. 5-1, 6-1, (Association of Bank Holdings Companies 1985); *Cf. Lane v. Chowning*, 610 F.2d 1385, 1390 (8th Cir. 1979) (where directors removed two officers, the 8th Circuit found authority for their action in a federal statute and the common law of Arkansas).

